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BEFORE THE
SURFACE TRANSPORTATION BOARD
Washington, DC 20423

In the Matter of: **SIMPLIFIED STANDARDS FOR RAIL RATE CASES**	**STB Ex Parte No. 646 (Sub-No. 1)**

SUPPLEMENTAL COMMENTS OF
ARKANSAS ELECTRIC COOPERATIVE CORPORATION

Arkansas Electric Cooperative Corporation ("AECC") respectfully submits these supplemental comments, which address issues raised in the Board's order dated January 22, 2007 and in the public hearing conducted on January 31, 2007.[1] The specific issues addressed herein include the following:

- the ability of the railroads to control sourcing patterns and levels of economic activity;
- the relationship between captive shipper rates and carrier investment needs in other facilities;
- the mechanics of "gaming" under different proposed eligibility criteria for Simplified-SAC;
- AECC's eligibility proposal;
- the incidence of rate case costs and benefits;
- route selection in Simplified-SAC; and,

[1] AECC's interest in this proceeding is described in Opening Comments of Arkansas Electric Cooperative Corporation (Oct. 24, 2006) (hereafter, "AECC Opening Comments") at pp. 1-3.

- the need for an URCS proceeding.

Each of these is discussed below.

I. RAILROAD CONTROL OF ECONOMIC ACTIVITY

At the public hearing, Vice Chairman Buttrey articulated a concern regarding the role of railroads as the "Deciders" of sourcing patterns and levels of economic activity. Transportation expenses often play an essential role in determining the viability of specific potential commodity flows, and it is reasonable and appropriate for the Board to give careful consideration to the ways railroads wield the pricing powers they hold over such flows under the Board's procedures.

To the extent that transportation rates reflect costs, it is economically efficient for transportation expenses to define market limits for specific flows. No one gets a "free ride", and goods produced in a given location will typically not be able to compete on a delivered price basis in all potential markets.

The issue that should be of concern to the Board is the degree to which the pricing latitude it provides to the railroads can be used to alter economic activity levels and patterns from the levels that would be established by efficiency considerations. AECC has recent first-hand experience with this issue, in the form of a lack of railroad cooperation on much-needed movements of substitute coal in the wake of the PRB Joint Line throughput problems that arose in 2005. Moreover, this issue appears to arise in a wide variety of commodity flows and geographical settings. For example, the Conrail break-up case alone saw both a well-publicized threat from a railroad traffic officer to divert volume from a specific port facility, and (during oversight) anecdotal evidence to the effect that the railroads were influencing shippers to locate facilities outside the North

Jersey Shared Assets Area. These are all practical manifestations of the "market power" that Vice Chairman Buttrey's comments appear to reference.

Throughout this proceeding, the railroads have consistently – and understandably – sought to cast their market power in the most benign possible light. However, they have provided no valid foundation – legal, theoretical or otherwise – for the Board adopt a casual posture regarding the exercise of that market power.

Indeed, an authoritative source cited by one of the railroad parties basically demolishes the entire collection of self-serving arguments that the railroads have offered regarding market power issues. In its rebuttal filing, UP attempts to rely on the textbook Economics to support UP's proposition that "...an increase in price when demand exceeds supply does not indicate an increase in market power..."[2] This textbook, now in its eighteenth edition, is authored by Nobel Prize-winner Professor Paul Samuelson of MIT and internationally-known Professor William Nordhaus of Yale. As noted in its Preface, "(f)or more than half a century, this book has served as the standard-bearer for the teaching of introductory economics in classrooms in America and throughout the world."

UP should read the book more closely. It plainly articulates several fundamental economic truths that conflict with railroad portrayals, but nevertheless should guide the Board's consideration of market power issues:

- "Market power signifies the degree of control that a single firm or a small number of firms have over the price and production decisions in an industry."[3]

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[2] Rebuttal Submission of Union Pacific Railroad Company (Jan. 11, 2007) at p. 3, note 4.

[3] Economics at p. 184.

- "When a firm has market power in a particular market…the firm can raise the price of its product above its marginal cost."[4] The existence of market power is defined by the relationship between price and marginal cost, and changes in that relationship provide the most direct imaginable indication of changes in the exercise of market power.
- Railroads are traditionally viewed as examples of "natural monopolies". A natural monopoly "…has perpetual increasing returns to scale, and average and marginal costs therefore fall forever. **As output grows, the firm can charge lower and lower prices and still make a profit**, since its average cost is falling."[5] (Emphasis added.)
- If volume increases have now exhausted railroad returns to scale, and further volume increases are increasing average costs, railroads can be viewed as oligopolies rather than natural monopolies. However, this would mean that the number of competitors should be increased in response to volume increases in order to ensure that each competitor operates at or near its efficient scale.[6] Failure to do so would be inefficient, since it would produce unnecessarily high total costs.
- It is also possible that in the wake of the long wave of rail mergers, the small number of remaining carriers have determined that it is advantageous to engage in more "cooperative" and less "uncooperative" behavior. "When only a few firms operate in a market, they will soon

[4] Economics at p. 161.

[5] Economics at p. 171. UP's attempt to rely on the response of prices in a perfectly competitive market to volume increases can therefore be seen as either highly misleading or highly misinformed.

[6] Economics at pp. 170-171.

recognize their interdependence….firms will surely recognize that each price cut is cancelled by competitors' price cuts."[7]

For the purposes of this proceeding, it is not necessary for the Board to reach any specific conclusions as to whether railroads have exhausted their economies of scale, or whether price increases reflect a reduction in competitive pressures. Rather, the Board can simply note that economic theory highlights the dangers of market power, particularly in highly concentrated industries (such as railroads). It completely refutes the railroad proposition that the Board should take a lax position regarding rail market power. "(I)ndusties characterized by imperfect competition…behave in certain ways that are inimical to the public interest."[8]

In the current environment, the Board's rate reasonableness procedures are one of very few defenses available to shippers to limit the exercise of rail market power. While some differential pricing is necessary, the Board should place a high priority on providing shippers with viable methods to effectively cap rates in the manner contemplated in the statutes and in the theory of Constrained Market Pricing. It is appropriate for the Board to keep railroad market power on a short leash to ensure that the proper role of competitive market forces as the "Decider" of economic activity is not unduly usurped by railroad management.

II. CAPTIVE SHIPPER RATES AND OTHER INVESTMENT NEEDS

At the public hearing, Chairman Nottingham raised a question regarding the role of revenue from captive shippers when railroads face investment needs in other facilities. Obviously, railroad investments are management decisions in which the Board and

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[7] Economics at pp. 186-187.

[8] Economics at p. 186.

shippers normally do not participate directly. Nevertheless, in setting maximum reasonable rates for captive traffic, it is important that the Board not let its valid concerns with overall revenue (and capacity) adequacy be used to undermine proper economic incentives for efficient management of this network industry.

In the Board's rate reasonableness procedures, the primary focus of the analysis is properly placed on the facilities used or required by the subject movement. This is a cornerstone of the theory of Constrained Market Pricing, and simultaneously ensures that (a) any rate relief provided to captive shippers will still permit the railroad to earn a market rate of return on the capital assets used by those shippers; and, (b) revenue from captive shippers will not cross-subsidize a carrier's endeavors in other areas.

Assuming the reasonableness of the Board's analytical procedures, traffic moving at a rate that provides a market return on the assets it uses cannot possibly bear any causal responsibility for a carrier's overall revenue inadequacy. By definition, any overall revenue inadequacy must stem from the portion of the carrier's network that the subject traffic does not use. Carrier management has abundant options for addressing under-performing portions of its network, including spinning-off or abandoning low-density lines, implementing efficiency/service improvements, and undertaking marketing/pricing initiatives. In some cases, it may even be rational for the railroad to consider investing in facility upgrades. However, for capital investment in any portion of the network to make economic sense, it must be justified on the volumes/rates/revenues/etc. associated with the traffic that would make use of the new facilities.

If the Board were to allow railroads to use captive shipper traffic to cross-subsidize the construction and/or operation of facilities it does not use, the incentives for economic efficiency in rail management decision-making would be undermined, and network sizing and operations would be distorted. A carrier should not build an intermodal facility in California if the only way it can pay for it is to charge "extra" on captive PRB coal movements to, say, Arkansas. The Board should therefore ensure that its procedures do not permit rates on captive shipments to rise above the level needed to pay for the facilities such shipments actually require.

III. ELIGIBILITY CRITERIA AND THE MECHANICS OF "GAMING"

AECC's opening comments presented an example that illustrated how, under the Board's initial eligibility proposal, the defendant railroad could set the initial rate in a manner that captures the leverage associated with a shipper's Full-SAC litigation costs.[9] AECC's rebuttal comments extended that example to the railroad proposal that would have the shipper prespecify a limit on the relief it was seeking.[10] Based on these illustrations, it is reasonable for the Board to give weight to the risk that any eligibility scheme that leaves the railroad with influence over the selection of Simplified-SAC vs. Full-SAC may leave the railroad with much or all of the leverage associated with a shipper's Full-SAC litigation costs.

This leverage enables railroads to obtain revenues above those contemplated by the statutes and by the theory of Constrained Market Pricing. It also prevents shippers from realizing the relief from Full-SAC litigation costs that motivated Simplified-SAC in the first place. With such leverage, the railroad can rely on a shipper's litigation costs to exploit its market power beyond the level otherwise permitted.

The Board's new proposal advanced on January 22 does not contain enough detail to know whether or not it will enable Simplified-SAC to deliver meaningful relief from

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[9] AECC Opening Comments at pages 4-5.

[10] Rebuttal Comments of Arkansas Electric Cooperative Corporation (Jan. 11, 2007) at pages 3-4.

the litigation costs of Full-SAC. The degree to which it does so will depend critically on the way the Board specifies the "limits on the relief available" from the different methods.

If the Board specifies the limit as a fixed dollar amount, the railroad would apparently still be able to set the rate so as to capture the leverage created by a shipper's prospective Full-SAC litigation cost. Under the proposed refinement, the railroad would simply need to ensure that the challenged rate exceeded the rate at which the shipper would be indifferent to a Full-SAC rate case[11] by the maximum amount of relief the Board would permit under Simplified-SAC, less the cost of putting on a Simplified-SAC case. Extending the prior examples, assume the Board limits the relief under Simplified-SAC to be no more than $3.5 M. Given that the shipper's cost of putting on a Simplified-SAC case is $0.2 M and that the volume at issue is 500,000 tons, an initial rate of over $28.00/ton[12] would ensure that Simplified-SAC provides the shipper with an inferior outcome in comparison to undertaking a Full-SAC case. Again, the latest proposal may affect the factors the railroad will consider in setting the initial rate, but it provides no new protection for the shipper against the ability of the railroad to set the initial rate in a manner that fully captures the leverage afforded by the shipper's prospective Full-SAC litigation costs.

If the Board defines the limit in the manner proposed in Section IV (below), this can be avoided.

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[11] Under the terms of the example, the shipper could achieve a rate at the 180 percent R/VC level ($14.40/ton) by litigating a Full-SAC case (at a cost of $7.00/ton). Holding aside risk considerations and discount rates, the shipper would not have any discernible economic incentive to undertake a Full-SAC rate case at any rate below $21.40/ton. Above $21.40/ton, the shipper prospectively could achieve savings by undertaking a Full-SAC case.

[12] Calculated as $21.40 + ((3,500,000-200,000)/500,0000).

IV. AECC'S ELIGIBILITY PROPOSAL

The Board should adopt the general framework presented in its order of January 22, 2007. Within this framework, the shipper is able to select Simplified-SAC or Full-SAC, subject to limits on the relief attainable from use of Simplified-SAC.

The Board should allow Simplified-SAC to be used without restriction whenever the relief in question does not justify use of Full-SAC. Initially, this would entail application of AECC's proposal that no limits on the use of Simplified-SAC be imposed where the combined Full-SAC litigation costs of the parties exceeds the amount in dispute.[13]

As more information becomes available over time regarding the magnitude of disparities between Simplified-SAC and Full-SAC, the Board should further apply this principle so that the incremental litigation costs of Full-SAC are not incurred unless justified by the magnitude of the expected error associated with use of Simplified-SAC that would be avoided by a Full-SAC presentation.[14] Put another way, to avoid squandering resources, the Board ideally should not require the parties to spend an extra $6.6 million[15] in litigation above the cost of Simplified-SAC unless the amount at risk of

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[13] At the public hearing, the AAR representative attempted to dismiss the AECC proposal as a "theoretical economic proposition" not based in statute. In fact, under U.S.C. Title 49, Subtitle IV, Part A, Section 10101 (5), the Board has a clear mandate under the national transportation policy "...to foster sound economic conditions in transportation..." Contrary to AAR's apparent wishes, the Board can and should ensure the economic soundness of its policies and requirements. Requiring parties to spend in litigation more than the value of a dispute would be economically unsound on its face. The AECC proposal avoids this outcome.

[14] This type of marginal analysis is consistent with, and essentially mandated by, economic theory. "*One of the most important lessons of economics is that you should look at the marginal costs and benefits of decisions...*" <u>Economics</u> at p. 179 (italics in original).

[15] Using the Board's estimated Full-SAC litigation cost of $3.5 M per party and Simplified-SAC litigation cost of $0.2 M per party, the incremental cost of Full-SAC litigation is ($3.5-0.2=) $3.3 M per party, or $6.6 M total. To the extent that actual litigation costs are found to differ from the Board's estimates, or if those estimates are otherwise changed, the incremental cost of Full-SAC litigation would need to be recalculated accordingly. Toward this end, it should be noted that at the public hearing Otter Tail Power's

error through use of Simplified-SAC is at least that much. It would be sound public policy for the Board to use this approach to ensure that its rules do not necessitate wasteful expenditures on litigation.

For shippers that elect to use Simplified-SAC above the limits established by litigation cost considerations, the Board should limit relief by incorporating a premium above the computed rate to ensure that the prescribed rate is not improperly low due to inaccuracies caused by the shipper's election to use Simplified-SAC. Any such premium should likely be small,[16] since the Board has already noted how Simplified-SAC omits any possibility for efficiency improvements relative to the defendant carrier's current actual operations. As further information becomes available over time regarding the degree of correspondence between Simplified-SAC and Full-SAC results, the premium could be modified accordingly.

The AECC proposal can be summarized as follows:

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litigation costs for its recent rate case were disclosed to be $4.5 M, and the defendant railroad (BNSF) concurred that its litigation costs in that case were well in excess of $3.5 M.

[16] In the absence of empirical information, an allowance of 5-10 percent would appear to be more than adequate.

Initial	In Future[17]
Use Simplified-SAC result when Actual Value of Case (AVC)[18] is less than or equal to $7.0 million (i.e., combined Full-SAC litigation cost)[19]	Use Simplified-SAC result (adjusted by the expected error of Simplified-SAC[20]) when the total expected error of Simplified-SAC is less than or equal to $6.6 million
Apply premium (5-10 percent) above Simplified-SAC result to mitigate errors if shipper uses Simplified-SAC when AVC is greater than $7.0 million	Apply premium above Simplified-SAC result (adjusted by expected error of Simplified-SAC) to mitigate potential errors if shipper uses Simplified-SAC when the total expected error of Simplified-SAC is greater than $6.6 million

In near term, this proposal diminishes the significance of gaming by permitting the shipper to obtain most of the benefits of Simplified-SAC regardless of the level of the initial rate set by the railroad. In the longer term, the possibility of gaming is eliminated, since the prescribed rate is not affected by the initial rate. This proposal also enables use of Simplified-SAC to change over time to adapt to the degree of accuracy and economy it is found to possess.

To facilitate this process, AECC endorses the comments of several parties to the effect that the Board needs to affirmatively monitor the performance of the new methodologies relative to Full-SAC.

[17] At such time as the expected error of Simplified-SAC can reliably be quantified.

[18] (Contested rate less target rate specified by shipper) x volume at issue.

[19] Computationally, this is equivalent to the private cost faced by each party, combined with a 50 percent likelihood of success.

[20] Computed as the percentage error of Simplified-SAC (i.e., the expected difference between Simplified-SAC and Full-SAC results, expressed as a percentage of the Simplified-SAC rate per ton) times the Simplified-SAC rate.

V. INCIDENCE OF RATE CASE COSTS AND BENEFITS

At the public hearing, Vice Chairman Buttrey posed a question regarding the incidence of rate case costs and benefits for shippers vs. carriers. As indicated by the BNSF representative, a railroad in a large rate case must look at the "big picture" in the sense that it likely serves several different captive shippers whose prescribed (or negotiated) rates might be affected by a given methodological change or precedent. On the other hand, very few shippers have multiple plants that would be impacted by precedents established in individual rate cases. For the carrier, the cost of rate case participation can therefore be diversified across many flows, while for the shipper it generally cannot.

A portion of the discussion at the public hearing also addressed the possibility that a shipper with multiple plants could protect itself from excessive differential pricing by making use of the negotiating leverage it holds by virtue of its size and its ability to shift output among plants. While some large shippers may have capabilities of this type, there are two major reasons why the Board should give no weight to this practice in the context of its rate reasonableness procedures:

- shippers who have meaningful options for constraining rail rates tend not to need rate case protection. Shippers who don't have negotiating leverage tend to be the ones that must rely on rate reasonableness procedures. The traffic of shippers who possess negotiating leverage moves at lower R/VC mark-ups that tend not to benefit under the Board's "maximum mark-up methodology", and may not even reach the jurisdictional threshold; and,

- essentially all past rail merger approvals have disregarded losses of leverage by multi-plant shippers (who lost the ability to shift traffic among separate railroads). For example, a shipper who previously could shift output between plants served exclusively by Burlington Northern and ATSF now has no such option. Similarly, a shipper who previously could shift output among plants served exclusively by UP, MP, WP, MKT, CNW, SP and/or DRGW now has no such option. Any effort by the Board to now rely on such leverage would trigger the need for an extensive review to correct the prior omissions.

As a practical matter, any attempt by a shipper to obtain leverage from a threat to litigate a rate case can only be viable if there are inequities in the incidence of rate case costs between shippers and railroads. At least some of the railroad parties have embraced and cited AECC's proposal that the costs of litigating a rate dispute be shared equitably between the parties. *Given that a rate case can provide a railroad with information that is* useful in its dealings with other customers, equity considerations clearly appear to support a significant degree of litigation cost sharing.

Even with something as basic as the Board's fee for processing a rate complaint, the Board could require that the cost be shared. Such practices should help get both parties on the same page to agree on a rate that is consistent with the statutes while minimizing unnecessary litigation.

VI. ROUTE SELECTION IN SSAC

Some of the railroad parties have tried to create the impression that the Board could safely rely on the carrier to route traffic efficiently, and that any shipper specification of an alternative route would be suspect. As addressed in further detail in

AECC's reply comments,[21] this argument overlooks the critical fact that the Simplified-SAC methodology is only applied in circumstances where the defendant railroad possesses significant market power. Especially in light of the Board's determination to apply the "maximum mark-up methodology" in the computation of prescribed rates, neither a shipper nor the Board can be confident that the carrier-selected routing for high-rated traffic will be the most efficient. Indeed, if the defendant carrier possesses enough market power for the Board's rate procedures (or the threat thereof) to provide a binding constraint, the carrier would appear to have a financial incentive to employ inefficient routings. The ability of shippers to specify an alternative route removes the profit potential from such strategies. While this issue likely would not come up in practice very often, the Board should not get rid of the only protection a shipper has when there is a problem of this type.

VII. NEED FOR URCS PROCEEDING

In Major Issues and in this proceeding, many questions have arisen regarding the validity of unadjusted URCS for specific applications. It would be appropriate for the Board to convene a proceeding to enhance and ensure the validity of URCS for these and other applications.

[21] Reply Comments of Arkansas Electric Cooperative Corporation (Nov. 30, 2006) at pp. 7-8.

AECC appreciates this opportunity to submit supplemental comments to address the outstanding issues in this proceeding.

Respectfully submitted,

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Certificate of Service

I, Tammy Hines, a secretary in the law firm of Keller and Heckman LLP, hereby certify that a copy of the foregoing Supplemental Comments of Arkansas Electric Cooperative Corporation have been sent, first class mail, postage prepaid, to all Parties of Record on this 26th day of February, 2007.

Tammy Hines

Tammy Hines